Board Walk

Briefing for Remuneration Committees

mm&k

December 2013

This edition of Board Walk includes:

Shareholder view

Iain Richards of Threadneedle Investments describes how he looks at executive remuneration and the new remuneration disclosure rules

When we consider a company's remuneration arrangements, we will generally focus on the six questions in the panel opposite.

When companies draw up their extensive remuneration reports they don't always consider the time constraints shareholders may have when it comes to reviewing them. At its worst, I have had as many as 14 reports & accounts to look at on a particular day and the remuneration report is just one small bit of them. The only practical way of managing that is to screen and speed-read them, to decide which need a more in-depth review.

So simplicity, relevance and clarity of the key messages are really important to me. Where the person drafting the report has thought about the reader's perspective and has, say, made intelligent use of graphs and tables, it really makes a difference.

Threadneedle questions for reviewing remuneration reports

1. Are they clear, simple and understandable? - we hope companies will avoid complex, overlapping or over-engineered arrangements
2. Are the package and its elements balanced and proportionate? – that is for example, in relation to other employees, competitors and the marketplace?
3. Is remuneration aligned with strategy? We look for a clear linkage to the strategic KPIs; consistency across what a company is telling us is important
4. Are payments subject to stretching performance conditions? - for LTIs, we look to see three-year forward looking measures, plus two further years of deferral with risk of malus (limiting that to material misstatement won't impress). We're not particularly keen on EPS as a measure. Despite the problems with its operation, institutional shareholders do like to see some linkage to TSR – after all it's the basis on which they themselves are rewarded
5. Do the policies mitigate the risk of rewards for failure? We attach particular importance to remuneration committees having an overriding discretion to ensure outcomes are appropriate

   and
6. Most importantly of all, do the arrangements deliver outcomes that reflect the outcomes for our clients? Over the crisis and subsequent downturn this has often not been the case. Banks do spring to mind here, but it's certainly not just them.

A good example of that is likely to be the new ten-year performance graph and associated pay and performance table. Whether or not we feel we need to do an in-depth review, it is something I expect to look at. However, companies will need to add a bit more information to the prescribed minimum if they want to tell their story effectively.

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The final new disclosure rules require companies to provide a statement for the coming year which will describe how they are intending to implement the approved future remuneration policy. This will be an important source of information to use in assessing the merits of policies. We have already seen some good examples of detailed but flexible policies in draft. A good one should, for example, provide the company with enabling rights (for example the discretion to add deferral to awards vesting from LTIPs where that is not current practice), allow for exceptional circumstances and enable reasonable flexibility to ensure outcomes are sensible.

We do not want to tie companies in knots as they adapt to the new legally binding regime, so we will generally look to be flexible with companies where we don't have concerns about how they are approaching pay in practice. That said, where a policy has been framed in rather general terms, we will certainly look to see more detailed explanations about the standards and approach that will be applied (a blank cheque approach won't impress!). Companies need practical flexibility, but we need to understand their focus and the boundaries they intend to operate within.

Generally we do not want to micro-manage companies or stop them applying common sense. Our real problem in this area often has more to do with companies paying excessively for going sideways or even backwards. We have little issue with real value creation being rewarded. There is one thing I would flag though: gold-plated executive pensions are almost certain to feature on the investor agenda now! Given the way the rest of the executive package has developed, the preferential arrangements that are seen in many cases simply can't be justified. It really is time for contribution rates to come into line with those for other employees.

Overall, I personally don't think that the blanket approach of the regulations will really add much (other than cost) – shareholders already had the tools required to intervene where it was needed, if they had wanted to. If the public commitments that led to this had been taken forward in a more focused and considered way, it might have been a different story.

Iain Richards is Head of Governance and Responsible Investment at Threadneedle Investments. Thread-needle is a leading active investment manager and the international investment management arm of Ameriprise Financial, one of the 40 largest asset management firms globally.

Directors' Remuneration Reporting Regulations

Damien Knight reports on a recent workshop on implementing the new regulations

On 14 November, MM&K and the law firm, Baker & McKenzie, jointly hosted a workshop where clients could compare and discuss their experiences in complying with the new remuneration reporting regime that began in October.

The reporting regulations are enshrined in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, that were passed in June, with modifications to the Companies Act 2006 providing the basis for binding shareholder votes on future policy. The Government invited the GC100 and Investor Group (a group of seven major companies and eight leading institutional investors) to develop the Directors' Remuneration Reporting Guidance which was issued on 12 September and represents the third key document that companies will need in preparing their remuneration policies and remuneration reports.

About 30 people attended the workshop. The new regulations apply to companies with year ends on and after 30 September 2013, so no reports under the new regime had yet been published. But most participants were heavily involved in preparing their policies and particularly in early discussion with their shareholders. Many companies had also introduced a number of the expected changes into their reports last year.

Iain Richards, Head of Governance and Responsible Investment, at Threadneedle Investments, delivered a keynote speech on the expectations of his firm for remuneration policy and reporting. The content of his presentation is reproduced in the leading article on Page 1 of this *Board Walk*.

The workshop itself tackled a number of questions: /…

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Should the 10 year Pay v. Performance chart and supporting table provide any more than the bare minimum?

Response

There was a general caution about disclosing too much at this stage for fear of setting a precedent.

Some companies will have difficulty completing the 10-year charts because:

- They have operated annual bonuses which did not specify threshold, target and maximum pay-outs (for example financial services pool-based bonuses with discretionary allocation)
- There is sometimes no relevant index or large benchmark.

Additional information which may be useful for shareholders includes:

- A comparison between the percentage increase of CEO's (single figure) total remuneration over the relevant period and the Company's TSR over that period.
- Notes to explain years where there has been a change of CEO
- Explanation of assumptions about maximum payouts as a percentage of salary where there is no formal maximum.

Another comment was that a company may choose to pay below median base salaries and as a consequence pay bonuses which are a higher percentage of the maximum than would a company with median/UQ base salaries with similar performance levels. In these circumstances, it could be helpful to explain this below the table.

Iain Richards said it was important to take advantage of the 10-year chart to tell your story, without making it over complex. But he cautioned about having too much explanation in the accompanying text which may not get read.

How are companies dealing with the need to draft a flexible, yet specific policy? Will they include 'emergency discretion' provisions in their policies? Where does policy stop and implementation start?

Response

It is important to have an answer for this because the future policy table is subject to a binding vote whilst the implementation statement is not:

- The future policy has to be sufficiently full and clear to enable investors to make an informed voting decision whilst not making the company a hostage to fortune or restricting its ability to manoeuvre within the policy to take account of changed corporate circumstances or changes in strategic direction
- There should be some provisions which would allow exceptional measures to be taken to retain a key director – though these will need to be drafted fairly tightly. Similarly, there should be provisions for the normal policy to be exceeded (within defined parameters) to recruit a new or replacement director
- There should be a provision to allow for adjustments to policy to take into account legal, tax and regulatory changes – again within certain parameters
- The critical thing is to set the discretion high enough to deal with, for example, a discrimination case. Companies do not want to end up in litigation – it is better to negotiate
- Much depends on risk profile, particularly the risk profile of the NEDs on the remuneration committee. If the remuneration committee is risk-averse, the remuneration policy statement is likely to follow the letter of the regulations and may leave little room for flexibility (and make the company a hostage to fortune) as a result. If the remuneration committee is not so risk-averse, the statement is likely to contain more flexibility
- However, if the policy statement is too general, there is a danger it will not be approved. So remuneration committees must know their investors. It is essential to maintain a constructive dialogue with investors as remuneration committees need to know where the investors stand as regards disclosure by the company (not in a general sense but with specific regard to the company). So, the answer to this question starts with a constructive dialogue between remuneration committees and investors and an understanding of what investors want.

How far do companies expect they will disclose actual targets (as opposed to measures)?

Response

There appears to be a general acceptance amongst shareholders that companies will not be able to disclose targets in the forward-looking part of the report. This is true of bonus plans, but also for LTIs where they are built around strategic objectives and KPIs

Even looking backwards there will be commercial sensitivity. One company that has consulted widely on

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this issue said shareholders are prepared to give you three years' grace. But then you have to report the actual targets.

How far have companies defined malus and clawback?

Response

There is a general acceptance now that the term "malus" applies when deferred amounts become forfeit, and "clawback" when a company has to pursue an executive to recover amounts already paid.

Most companies said they had done a lot of work in defining where malus would apply. Generally this would be in cases where earlier performance was overstated, but frequently also where later company performance was poor. One participant said that reduced dividends would be a cause for reducing deferred payments. Companies had done less work on clawback – it was likely to apply in cases of dismissal for gross misconduct.

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This workshop will be run again on 15 January at 4.00pm at the Baker & McKenzie offices in New Bridge Street, London EC1.

Finalising your Remuneration Policy and Report
Hosted by Baker & McKenzie and MM&K
Wednesday 15 January 2014, 4.00 - 6.00 pm followed by drinks and canapés

For anyone who is involved in preparing directors' remuneration reports under the new regime for UK quoted companies

If you would like to participate, please contact Tracy Smith: tracy.smith@mm-k.com

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Sauce for the goose

Paul Norris investigates investors' expectations for retaining shares

The institutional investor, Fidelity, has written to FTSE 350 companies saying that, from 1 January 2014, it will vote against directors' remuneration reports if the period from the date of an LTIP grant to the date when vested shares can be sold is not more than three years. From 1 January 2015, Fidelity will vote against if the holding period is not at least five years. Fidelity is not concerned here with the vesting period or the period over which performance is measured.

Other institutions have not adopted so entrenched a position but there are indications of mounting pressure for longer holding periods. HSBC operates a so-called "career share" plan, which is consistent with Fidelity's guidance, requiring the retention of vested shares until employment ceases. Time will tell if this creates an incentive to leave at the top of the market. One of the criteria used by Threadneedle Investments to assess LTIPs is that a two-year holding period should follow a three-year vesting period (see article on Page 1 by Iain Richards). The NAPF CEO, Joanne Segars, was recently quoted as saying; "We expect remuneration committees to set rewards which drive long-term strategic success and seek to reward performance over the longer term; in most cases this will be longer than three years."

MM&K has long argued that LTIPs should reflect the investment and return cycles of the company. Hermes seems to agree. Its guidance states; "The strategies, capital projects and investment decisions for FTSE 100 companies take far longer than three years to be specified, implemented and assessed. Timescales of these projects should be better reflected in incentive schemes to discourage short-term thinking and decision making."

Table A opposite displays the guidance from a range of investors and shareholder agencies.

LTIPs should reward management success measured against strategic KPIs. Performance measurement periods should reflect the investment and return cycles of the business. If adopted by construction, oil & gas and mining companies, for example, this would result in plan periods longer than three years. For companies whose cycles are shorter, e.g. technology, fashion or retailing, the use of LTIPs may not be appropriate at all.

We would agree that long-term shareholding achieves alignment but will institutions requiring management to retain shares for five years also make the same commitment? For many such investors a two-year holding is a long-term investment.

To discuss this further, please contact Paul Norris at

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Table A

Investing house or agency	Position on share retention	Source
Legal and General IM	Shareholding requirements should be meaningful, taking into account the size of the company and potential size of share awards received. A company granting annual awards of shares with a face value of 400% of salary should set a target shareholding of at least 4x salary to be achieved within a 5-year period. Unvested shares do not count.	UK corporate governance policy
M&G Investments	Our preference is for deferred share ownership plans with dividend accrual on shares which vest rather than for share option schemes. We expect directors to have a direct shareholding in the company which is substantial in the context of their remuneration.	Issues arising from share ownership
ABI-IVIS	Executive Directors and senior executives should build up significant shareholdings in companies. Unvested share-based incentives should not count towards these requirements. The performance period of LTI schemes should be clearly linked to the timing of the implementation of the strategy of the business, which should be no less than three years and shareholders would generally prefer longer. Committees should consider the use of additional holding periods.	ABI policy
NAPF, Hermes EOS, BT Pension Scheme, Railpen, USS	Management should make a material long-term investment in shares of the business they manage. The meaning of "long-term" will differ from company to company but three years, the most commonly used time period for long-term awards, is often not long enough. In many situations it may be appropriate for a material proportion of shares granted to be held for a longer period. Companies should also consider ensuring that executives are exposed to some tail risk once they have left a company.	Joint remuneration principles
Threadneedle Investments	Threadneedle expects directors to hold a meaningful share in the companies they manage. LTI awards granted to directors should not vest in less than three years, with an additional two-year holding period. Effectively, managers should hold their shares for a period of 5 years.	http://www.threadneedle.co.uk/media/1392381/en_corporate_governance_policy.pdf
PIRC	PIRC will oppose the introduction of all new long-term incentive plans as part of a significant shift in its analysis of governance issues. Managing Director of PIRC - "LTIPs are not long term and they do not incentivise. They are also ineffective due to amendments and manipulation by remuneration committees."	UK Shareholder voting guidelines 2013

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Share plans update

Mike Landon looks at the latest changes in tax-advantaged share plans

The Chancellor's Autumn Statement on 5 December 2013 included long-awaited increases to the individual participation limits for all-employee Share Incentive Plans (SIPs) and SAYE Share Option Schemes. From 6 April 2014 the limits will change as in Table B.

Table B

	SIP Free Shares	SIP Partnership Shares	SAYE
Existing limit	£3,000 per year	£1,500 per year (£125 per month)	£250 per month
New limit	£3,600 per year	£1,800 per year (£150 per month)	£500 per month

These announcements follow the large number of improvements to the tax-advantaged share plans in this year's Finance Act resulting from the recommendations of the Office of Tax Simplification (OTS), to which I contributed as a member of the Share Schemes Consultative Committee.

The draft clauses for next year's Finance Bill, published on 10 December, contain details of the self-certification arrangements which will replace the HMRC approval process for SIP, SAYE and CSOP from next April (including the penalties for non-compliance).

They will also implement some of the OTS's recommendations relating to unapproved share plans, including those in Table C below.

Table C

Internationally mobile employees	The income tax and NICs treatment of share and share option awards to these employees will be more closely aligned with that which applies to other employment income.
Corporation tax deduction	CT relief will not be lost after a company has been taken over by an unlisted company provided the shares are acquired by employees within 90 days of the takeover.
Restricted securities and partly-paid shares	There will no longer be an income tax charge triggered when these shares are exchanged for new securities, for example following a takeover.
Section 222 charge	The deadline for employees to make good a PAYE payment made by their employer is to be extended from 90 days after the taxable event to 90 days after the end of the tax year.

MM&K will be issuing a detailed Share Plans Update later this month.

For further information contact michael.landon@mm-k.com.

Institutions update their guidelines

Cliff Weight and Mike Landon look at the key points

NAPF – a re-emerging force

For many years the National Association of Pension Funds (NAPF) played a supporting role to the Association of British Insurers (ABI) in shaping and curtailing executive pay. Following a joint venture with the American corporate governance services firm, ISS, and the eventual acquisition of the NAPF proxy advisory service arm, RREV, by ISS, the NAPF restricted their involvement to setting the guidelines on which ISS based their shareholder advice in Europe.

This looks like changing. On 11 October the NAPF announced that they are not renewing its licensing agreement with ISS next June. Freed of any commercial obligations to ISS, the NAPF will be able to pursue issues in the best interests of their members.

We are already seeing signs that the NAPF plan to be more high profile in shareholder engagements and we can expect a change in the role and importance of the NAPF in corporate governance matters. In recent announcements they have advocated both an increased

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focus on management's material investments in shares and a requirement for pay to be more aligned to long-term sustainable success. They are working with the Investment Managers Association and leading investors to try to form a group of investors that companies could consult and engage with on corporate governance issues.

They have also removed the reference to the ABI Remuneration Principles in its earlier guidelines. This might be because they no longer wish to align themselves so closely with the ABI or the ABI Remuneration Principles.

On 18 November 2013 they issued their new Corporate Governance Policy & Voting Guidelines. This document cross refers to the Remuneration Principles for Building and Reinforcing Long-term Business Success, a document issued on the same day in conjunction with USS, Railpen and Hermes. The latter identifies the five principles in Table D following:

Table D

1.	Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage
2.	Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation
3.	Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders
4.	Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance
5.	Companies and investors should have appropriately regular discussions on strategy and long-term performance.

ABI revised principles

The Association of British Insurers ('ABI') issued a revised version of their Principles of Remuneration on 5 November 2013. The main changes from last year's guidelines are as follows:

Performance adjustment, malus and clawback

The ABI already required annual bonus and long-term incentive awards to include provisions for the awards to be reduced or forfeited before the payment or vesting date in specified circumstances ('performance adjustment' or 'malus'). Companies must also be able to recover amounts already paid to executives ('clawback'), though it is accepted that this is likely to be in a more limited range of circumstances.

There is now a requirement that the circumstances in which malus or clawback will be applied should be agreed and documented before the awards are made and these circumstances should be clearly disclosed to shareholders.

Executive shareholdings

It is expected that executive directors and senior executives should build up significant shareholdings in their companies. It has now been confirmed that unvested plan shares should not count towards satisfaction of the shareholding requirement. However, shares acquired from awards which have met the vesting conditions but are still subject to a holding period and/or potential clawback will count.

Performance on grant schemes

The ABI's normal requirement is for vesting of long-term incentive awards to depend on performance achieved during a period of three or more years from the date of grant. They accept, however, that there are some circumstances, for example for certain US executives, in which it may be appropriate for awards to be based on performance before the grant date. The ABI update specifies that in these cases:

- The practice should be carefully justified and there should be clear disclosure in advance of the performance required.
- The value awarded should be significantly lower than for awards which are subject to performance conditions on vesting.
- There should be genuinely long holding periods and significant shareholding requirements.

New reporting and voting regime

The ABI have confirmed their support for the new directors' reporting regulations and the guidance issued by the GC100 and Investor Group. On specific issues:

- They expect the Policy Report to be voted on every three years and not on an annual basis. However, the Policy Table should be disclosed in the Remuneration Report every year.
- The new Remuneration Policy should apply immediately after shareholder approval, not delayed until, for example, the next financial year.
- Companies should only rely on the 'commercially sensitive' exemption from disclosing performance targets 'by exception' and this should be clearly justified to shareholders.
- Companies should provide a full and clear explanation of the key decisions the Remuneration Committee has made during the year and the reasons for them.

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- The maximum variable remuneration which can be paid to a new director must not be excessive and any significant differences between normal policy and recruitment policy must be clearly justified.

For further information contact

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Alternative investment sector remuneration news

Nigel Mills describes the headlines from two recent private equity surveys and provides an update on the FRC implementation of the AIFM Directive.

In the last few months MM&K has published both its Large Buy-Out Compensation Survey and the wider Global Private Equity and Venture Capital Compensation Survey that we conduct in conjunction with Holt (a US Compensation Consultant) and Thomson Reuters.

The European report provided some interesting insights into what is happening in the world of Private Equity pay. The data indicated that salaries had increased more or less across the board for both investment professionals and back office staff. However salary increases tended to be at around the 3% mark other than at the Associate level. We can report that the VC sector of the market were in a position to make increases in salaries across the board and at around the 7% level for the Associate roles. Even more encouraging was that bonuses paid for 2012 performance were generally significantly up on 2011 bonuses, again most notably at the Associate level. Expectations for the next round of salary and bonus reviews were suggesting that salaries are going to rise by around 4% in the industry while bonuses are expected to be flat or marginally up on 2012.

The letters on everyone's lips in the European Private Equity industry are AIFMD. The Alternative Investment Fund Managers Directive came into effect on 22 July 2013. EU Member States were required to comply with AIFMD by 22 July 2013, subject to transitional provisions for managers who were managing AIFs before that date. "Managing" under AIFMD means carrying on the activities of portfolio management and risk management for one or more AIFs. Existing AIF managers must be appropriately authorised from 22 July 2014. The FCA has up to six months to determine applications. This means new Applications or Variations of Permission (VoPs) need to be submitted by 22 January 2014 to guarantee they will be dealt with before the deadline. **STOP PRESS – ON 19TH DECEMBER HM TREASURY ANNOUNCED SOME RELAXATION IN THIS TIMETABLE.**

The AIFMD has a lot to say about remuneration. It focuses on two main areas – disclosure requirements and structures. In terms of structure, AIFMs must ensure that a substantial portion of variable remuneration consists of units or shares in the AIFs concerned (or other instruments depending on the legal form of the AIF). There is also a significant deferral requirement – variable remuneration must not be paid by an AIFM unless a substantial portion (at least 40%) is deferred over a period that is appropriate to the life-cycle of the fund. This is increased to 60% if variable remuneration is particularly high. AIFMs should also ensure that any variable remuneration vests only if it is sustainable in accordance with the financial position of the AIFM as a whole and is justified in accordance with the performance of the AIF, the individual and the relevant business unit. These rules together are referred to as the pay-out process rules. AIFMs may apply proportionality to these rules and in doing so may disapply them. Many PE and VC firms are taking advantage of the proportionality rules and are arguing that the structure of their carried interest arrangements satisfies all the alignment of interest requirements with investors and avoids incentives for inappropriate risk taking. Interestingly, in a pulse survey of PE and VC houses that we conducted earlier this year, 77% of respondents said that they did not expect that they would have to introduce deferral of any variable pay over and above that which they were already doing (i.e. through their carry plans).

The disclosure requirements are not avoidable through the proportionality rules and require that the annual report contains:

(1) the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries and, where relevant, carried interest paid by the AIF;

(2) the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

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